



Appeal of Kroehler Manufacturing Company

The issue is whether rebates paid to appellant **on** the liquidation of its qualified pension plan constitute business income **includible in income** subject to apportionment for California tax purposes, or nonbusiness income specifically allocable to appellant's out-of-state domicile.

Appellant is an Illinois corporation with its main office and commercial domicile at Naperville, Illinois. Appellant, together with its subsidiaries, is a unitary business engaged in the manufacture and sale of furniture.

On November 30, 1956, one of appellant's subsidiaries, Kroehler Manufacturing Company of Kentucky (hereinafter the subsidiary), purchased the assets of the Furniture Division of the **Mengel** Company (hereinafter the Furniture Division). As part of this acquisition, the subsidiary entered into an agreement with the Guarantee Trust Company of New York whereby the **Mengel** Savings and Retirement Plan (hereinafter the Plan) would be continued and maintained. No part of the purchase price was allocated to the Plan. After the acquisition the operations of the Furniture Division continued substantially as before, although under the ownership of the subsidiary. Subsequently, the subsidiary was merged into appellant.

Prior to the acquisition, the Mengel Company had contributed a total of \$1,227,152.87 to the Plan. As of the date of the acquisition, the assets in the Plan were valued at \$2,023,516.60. After the acquisition, appellant contributed \$671,851.41 to the Plan. This amount was deducted as an expense from appellant's business income during the appropriate years. Since the Plan was a qualified plan, no tax was paid on the contributions or the investment income of the Plan by the Mengel Company, by appellant, by the employees, or by the trust either to the federal government or to any state.

During 1968, appellant terminated its operations in Kentucky. Consequently, it became necessary to liquidate the Plan. The employees were given the election to receive either a cash payment of their vested interest or an annuity purchased **by the fund**. The value of the Plan assets at the time of liquidation far exceeded the amounts necessary to satisfy all liabilities. After all: the employees had received benefits according to their **election** and after all expenses had been paid, the fund contained a surplus of **\$3,465,256.56**. This amount **was** rebated to appellant:

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On its 1968 California franchise tax return, appellant reported the rebated amounts as nonbusiness income attributable to its commercial domicile in Illinois and, therefore, not subject to California franchise tax. Respondent's determination that the pension rebates were business income subject to apportionment gave rise to this appeal.

Appellant is **concededly** a unitary business: therefore, all business income shall be apportioned to this state on the basis of an apportionment formula. (Rev. & Tax. Code, § 25128.) Nonbusiness income is specifically allocable. (Rev. & Tax. Code, § 25124-25127.) Business income is defined as:

[I]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. (Rev. & Tax. Code, § 25120, subd. (a).)

Nonbusiness income is defined as "all income other than business income." (Rev. & Tax. Code, § 25120, subd. (d) .) The regulations further provide that an income item is business income unless "clearly classifiable as nonbusiness income." (Cal. Admin. Code, tit. 18, reg. 25120, subd. (a) (art. 2).)

In the Appeal of Borden, Inc., decided February 3, 1977, we noted that the definition of "business income" contained in section 25120 was patterned after the definition of "unitary income" as formulated in prior opinions of this board and concluded that the appropriate construction of "business income" is the same as the prior functional test used for determining unitary income. Applying that test in Borden, we held that "business income" includes income-from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations, even though the income may arise from an occasional sale or other extraordinary transaction.

In the instant appeal, appellant acquired all the assets of the Furniture Division, including its interest in the Plan, in a single transaction. The purpose of the transaction was to acquire assets which would

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further appellant's unitary business which was **manufacturing and** selling furniture. In order to conduct these operations it was necessary to hire employees to perform the required labor. As an inducement to retain the current employees of the Furniture Division and to attract other qualified **employees**, appellant maintained the Plan. When the operations in Kentucky were terminated, it was necessary to satisfy the existing liabilities to the employees and to liquidate the **Plan's** assets. After fully satisfying all existing liabilities, appellant, the residuary beneficiary of the Plan, received the surplus assets as a rebate. It is apparent that the **acquisition**, maintenance, and disposition of the Plan constituted integral parts of appellant's manufacturing and sales business. Accordingly, the surplus distributed to appellant constituted business income subject to formula apportionment. (Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

In support of its position appellant relies on **three** decisions of this board. (Appeal of Fibreboard Products, Inc., Cal. St. Bd. of Equal., Feb. 17 1959; Appeal of American Airlines, Inc., Cal. St. Bd. of Equal., Dec. 18, 1952; Appeal of American President Lines, Ltd., Cal. St. Bd. of Equal., Jan. 5, 1961.) In Appeal of General Dynamics Corporation, decided June 3, 1975, we distinguished Fibreboard Paper Products Corp. v. Franchise Tax Board, 268 Cal. App. 2d 363 [74 Cal. Rptr. 46] (1968) and American President Lines, Ltd. v. Franchise Tax Board, 3 Cal. App. 3d 587 [83 Cal. Rptr. 702] (1970) involving similar issues, as well as our prior decision in Appeal of American Airlines, Inc., supra. We also noted that since all three matters arose before the effective date of the Uniform Division of Income for Tax Purposes Act (Rev. & Tax. Code, §§ 25120-25139) and the regulations issued thereto, the income from intangibles involved in those decisions **would** now be business income.

As an alternative argument, appellant contends that, **if** the rebates are not considered nonbusiness income in their **entirety**, at least part of the rebates should be considered attributable to contributions made by the **Mengel Company and, therefore**, nonbusiness income. We do not agree. **No** income from the Plan was accrued to the **Mengel Company**, nor did the **Mengel Company** have any vested interest **in the** Plan at the time of the transfer. The entire amount of the rebates was earned by appellant

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in **the** acquisition, maintenance, and disposition of an asset used in the unitary business. Therefore, the entire amount **of** income earned *on the* liquidation of that asset must **be** business income.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Kroehler Manufacturing Company, against a proposed assessment of additional franchise tax in the amount of **\$17,503.56** for the income year 1968, be and the **same** is hereby sustained.

Done at Sacramento, California, this 6th day of April, 1977, by the State Board of Equalization.

William L. Berglund Chairman
George A. Jones Member
Robert C. Allen Member
_____, Member
_____, Member

ATTEST: *W. W. Dunlop*, Executive Secretary